Scottish & Southern Electricity Networks and other interested parties

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Deputy Director
Energy Systems, Management and Security
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Derogation to Scottish & Southern Electricity Networks (SSEN) Distribution pursuant to SLC 13B Part E of the Electricity Distribution Licence

We have granted a derogation to SSEN to charge outside of its methodology for extra high voltage (EHV) customers for 2025/26. Specifically, it allows SSEN to carry over locational components and Network Use Factors of the 2024/25 charge setting process to the 2025/26 charging year. We consider it is in the interests of its customers overall, and in particular its EHV customers, to mitigate what would otherwise have been an exceptional level of volatility in charges and maintain the tariff notice period.

Background

Distribution Network Operators (DNOs) recover their allowed revenue from customers through Distribution Use of System (DUoS) charges. The methodologies for calculating these charges are the EHV Distribution Charging Methodology (EDCM) for the large, industrial customers connected at the highest voltages, and the Common Distribution Charging Methodology (CDCM) for the remaining customers. The CDCM and EDCM are detailed in the Distribution Connections and Use of Systems Agreement (DCUSA) document.

There are two versions of the EDCM methodology. Each of the DNO licensees selected one to adopt on an enduring basis when the EDCM was introduced: the Forward Cost Pricing (FCP) or the Long Run Incremental Cost (LRIC) methodologies. This issue so far only appears to have the potential to affect those DNOs using the FCP methodology.

SSEN's issue

SSEN Distribution first contacted us about this issue in October, and its derogation request, of 14 November 2023, is published alongside this letter.[1] In its letter, SSEN states that it discovered an issue with the EDCM methodology while preparing 2025/26 tariffs, due to be published by 31 December 2023.

In its letter SSEN explains that:

> "the draft EHV tariffs produced by the EDCM for 2025/26 indicate that final demand customers would receive large payments (i.e. credits) via the 'residual' component of the charge, despite the model also indicating that load growth is the main driver of network cost…
>
> "These results are a consequence of the 'forward-looking' component of the charge (based on our ten-year ahead demand projections and network development plan) overshooting the target revenue for the EDCM (based on 2025/26 Allowed Revenues). The methodology dictates that large negative residual charges (i.e. payments to final demand customers, paid for by non-final demand customers) are required [to] bring overall revenue recovery back down to the target level. Higher capacity final demand customers receive a larger credit due to having a higher residual banding. Lower capacity final demand customers receive a smaller credit. These payments are funded by non-final demand customers, most of whom receive large, volatile increases in their charges."

Since being contacted by SSEN, we have sought views from other DNOs to understand if they may be affected by a similar issue. We understand that the other two DNOs most likely to be affected are those using the FCP methodology, namely Scottish Power Electricity Networks and two of National Grid Electricity Distribution's licence areas. They have indicated to us that they will not be affected by this issue for 2025/26, though caution that this issue may arise for them in future years.

SSEN's proposal

SSEN's letter goes on to state:

> "Given the disruptive commercial ramifications that such drastic year-on-year changes could have for our EHV customers (and the counter-intuitive behaviours this may incentivise), we do not think it would be in their interests to publish tariffs

[1] We have asked SSEN to redact some elements of the letter to maintain commercial confidentiality with respect to tariffs.

based on a methodology that is not producing coherent results under a load-growth outlook for which it was not designed."

Having considered and discussed a number of options with us, SSEN proposes to carry over the FCP locational components and Network Use Factors (NUFs) of its 2024/25 tariffs, whilst in all other respects updating the model to reflect the latest data in accordance with the EDCM. It considers this would be the best option to ensure charge stability for its customers while offering transparency, based on its prior year publications.

To enable this, SSEN has proposed a derogation from Ofgem to charge other than in accordance with the EDCM FCP methodology by carrying over these components of the 2024/25 tariff calculations. It believes it is in the interests of its customers to ensure that tariffs continue to be published in accordance with the charge-setting timetable (i.e., by 31 December 2023) with minimal disruption.

Our assessment of SSEN's proposal

We have considered SSEN's proposal to carry over the relevant components of its 2024/25 tariff calculations against our principal objective and wider statutory duties. We have considered whether alternative solutions, such as derogations to the 15-month tariff notice periods and a period of further investigation, would better facilitate the achievement of these objectives and duties.

Competition

SSEN notes that the draft EHV tariffs produced by the EDCM for 2025/26 produce high "forward-looking" charges, with many sites seeing very significant year-on-year changes. So much revenue is recovered from these charges that to stay within the EDCM target revenue, some EHV users would face negative "residual" charges. We think such a dramatic change in the level of charges is potentially harmful for competition. Negative residuals could lead to distortive incentives for customers to hold or increase agreed capacity where it is not needed, which will not lead to efficient system use and could be harmful for competition if it prevents the efficient allocation of capacity to other users.

We have signalled our intention to look into the presence and impacts of volatility of EHV DUoS charges as part of our DUoS Reform Significant Code Review (SCR) work. We have not formed an opinion on whether broader intervention is needed, but think that a swing from significant positive fixed charges to significant negative fixed charges was unlikely to be predictable to users and so does not aid business planning or investment certainty. Where forward-looking charges for non-final demand users (such as generation and storage users) have increased significantly, this may affect the competitive position of these users in their respective markets. Such significant year-on-year changes may be challenging to incorporate into operating budgets. SSEN's proposal would address these competition concerns in the short term.

Cost reflectivity

Absent this derogation, SSEN's EDCM unit and capacity charges would over-recover revenue and then pay fixed credits that do not send a signal for reducing the long run costs of the distribution network. This suggests the over-recovery is inefficient and unnecessary when compared to alternatives such as recovering less in the first place. At a time when both domestic and non-domestic users are facing higher costs of energy, it does not seem reasonable to see consumer money paid out to users in standing charges or for excessively volatile or high unit rates affecting business decisions without clear justification.

Process

We recognise that SSEN's proposed solution is not the only possible solution, so we have also considered the potential for a derogation from the tariff setting notice periods to allow industry to investigate further. While this may have some benefits, such as the potential to identify and address any other related issues in a holistic way, we have concluded the SSEN proposal is likely to be the most proportionate route to take. In particular, the SSEN proposal would not lead to a delay in publishing tariffs within the usual timelines, something that would potentially affect all suppliers and all customers in its two licence areas.[2] Such a delay could hinder suppliers' ability to price and offer supply contracts, and could increase uncertainty and prevent plant operators understanding costs for the period of any delay.

Under SLC13B.5, licensees must review the EDCM methodology at least once a year and make such modifications to the methodology as are necessary for the purposes of better achieving the Relevant Objectives.[3] Typically, such a modification would be enabled via a proposal to DCUSA to proceed to industry working group development and ultimately for Ofgem decision. In this instance, with the issue only being identified with fewer than three months before charges are due to be published, the usual modification timetable would add significant uncertainty to the tariffs for affected parties. That is, were any such modification ultimately approved, it would significantly reduce the notice period for charges (to a matter of months) and introduce further uncertainty as a result of relatively short-notice changes to published charges.

[2] This is because outputs of the EDCM are used in the calculation of CDCM charges and vice versa.
[3] The Relevant Objectives are listed in SLC 22A Part B.

In addition, we are currently conducting a SCR into DUoS, which limits the ability of DNOs to propose modifications to the charging methodology which overlap with the scope of that SCR. We have recently sought views on our proposal to examine EDCM volatility in the next phase of that SCR.[4] We will seek to ensure that work considers the causes of the volatility that gave rise to this issue. In particular, we will examine SSEN's concerns that the FCP EDCM model was not necessarily designed to deal with the type of strategic network investment that a net zero investment programme is likely to require.

We encourage DNOs to examine likely future charges in as far as advance as practicable to ensure any such issues are identified as early as possible.

Decision

We have considered the request in accordance with our principal objective and statutory duties. We have decided to grant the requested derogation in accordance with the Direction below. This letter sets out the reasons for our decision under section 49A of the Electricity Act 1989.

Direction

The Authority hereby directs:

Pursuant to SLC 13B Part E of the Electricity Distribution Licence, Scottish Hydro Electric Power Distribution plc and Southern Electric Power Distribution plc may carry over the FCP locational components and NUFs of the 2024/25 charge setting process to the EDCM for the 2025/26 charging year. Any new EDCM connections between the publication of charges and the 2025/26 charging year should also have their charges set on an equivalent basis. For the avoidance of doubt, and save as set out in this Direction, in all other respects the model should use the latest data in accordance with the EDCM.

The direction shall have effect from the date stated below.

Dated 01 December 2023

Yours faithfully,

Eleanor Wood
Deputy Director, Electricity Access and Charging

Signed on behalf of the Authority and authorised for that purpose

[4] https://www.chargingfutures.com/media/1602/cff-slide-pack-31-october-2023-final.pdf – see slides 38-41.